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In the Supreme Court of the United States

OCTOBER TERM, 1950

No. 160

REYNOLDS SPRING COMPANY, A DELAWARE CORPORATION, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The opinion of the Tax Court (R. 20-26) is reported at 12 T.C. 110. The opinion of the Court of Appeals (R. 48-53) is reported at 181 F. 2d 638.

JURISDICTION

The judgment of the Court of Appeals was entered on April 19, 1950. (R. 47.) The petition for

a writ of certiorari was filed on June 29, 1950. The jurisdiction of this Court is invoked under 28 U.S.C., Section 1254.

QUESTION PRESENTED

The taxpayer had received, as a contribution to its capital, certain property, in exchange for which it had issued its own shares of capital stock. Later, but prior to the taxable year, the taxpayer distributed this property to its shareholders at a time when it possessed a deficit in its earnings and profits account. When distributed, the property possessed a market value which was less than its tax basis to the taxpayer.

Under Section 718(a)(2) of the Internal Revenue Code, there was properly included in the taxpayer's equity invested capital, as property paid in for stock, the unadjusted basis of the property for determining loss. Section 718(b)(1) requires that equity invested capital shall be reduced by the amount of prior distributions which were not out of accumulated earnings and profits.

The question is whether, as the courts below held, the amount of the reduction under Section 718(b)(1) is determined by the tax basis of the property to the distributing corporation, or whether, as the taxpayer contends, the amount of the deduction is determined by the fair market value of the property at the time when it is distributed by the corporation.

STATUTE INVOLVED

Internal Revenue Code:

SEC. 718 [as added by Section 201, Second Revenue Act of 1940, c. 757, 54 Stat. 974]. EQUITY INVESTED CAPITAL.

(a) *Definition.*—The equity invested capital for any day of any taxable year shall be determined as of the beginning of such day and shall be the sum of the following amounts, reduced as provided in subsection (b)—

(1) *Money paid in.*—Money previously paid in for stock, or as paid-in surplus, or as a contribution to capital;

(2) *Property paid in.*—Property (other than money) previously paid in (regardless of the time paid in) for stock, or as paid-in surplus, or as a contribution to capital. Such property shall be included in an amount equal to its basis (unadjusted) for determining loss upon sale or exchange. If the property was disposed of before such taxable year, such basis shall be determined in the same manner as if the property were still held at the beginning of such taxable year. If such unadjusted basis is a substituted basis it shall be adjusted, with respect to the period before the property was paid in, in the manner provided in section 113(b)(2);

(3) *Distributions in Stock.*—Distributions in stock—

* * * * *

(4) [As amended by Section 203, Revenue Act of 1941, c. 412, 55 Stat. 687] *Earnings and Profits at Beginning of Year.*—The accumulated earnings and profits as of the beginning of such taxable years;

* * * * *

(b) *Reduction in Equity Invested Capital.*—The amount by which the equity invested capital for any day shall be reduced as provided in subsection (a) shall be the sum of the following amounts—

(1) *Distributions in Previous Years.*—Distributions made prior to such taxable year which were not out of accumulated earnings and profits;

(2) *Distributions During the Year.*—Distributions previously made during such taxable year which are not out of the earnings and profits of such taxable year;

* * * * *

(26 U.S.C. 1946 ed., Sec. 718.)

STATEMENT

This case involves asserted deficiencies in excess-profits taxes. The pertinent facts were stipulated (R. 35-39) and were found by the Tax Court as stipulated (R. 20-24). In 1924, the taxpayer, which had been incorporated in 1919, acquired all the capital stock (6,438 shares) of General Leather Company. In payment for the General Leather Company stock, the taxpayer issued 210,548 shares

of its own common stock. The fair market value of the General Leather Company stock acquired by the taxpayer, and the book value of the stock issued by the taxpayer, was $2,412,875.83 each. This amount was credited to the taxpayer's capital stock account. (R. 20, 21-22, 35, 36.)

Immediately prior to March 31, 1931, the taxpayer had an "earned surplus deficit" of $698,-760.84. On that day, it distributed all the General Leather Company stock to its shareholders, the original shares having been increased from 6,438 to 148,566 by a split-up which was designed to facilitate the distribution. The distribution was made pursuant to a prior resolution of the taxpayer's board of directors, which had denominated the distribution as a "liquidating dividend." The fair market value of all the General Leather Company stock at the time of the distribution was $742,830. The original book value of the stock, $2,412,875.83, was charged to capital surplus on the taxpayer's books. (R. 22-23, 37-38.)

In computing its excess profits tax credit based on invested capital, the taxpayer, under Section 718(a)(2), Internal Revenue Code, included in its equity invested capital the original book value of the General Leather Company stock (which was also its unadjusted basis for determining loss), namely, $2,412,875.83, as property paid in for stock, but decreased its equity invested capital, under Section 718(b)(1), as a prior distribution

not out of earnings and profits, only by the value of the stock when distributed. (R. 23, 38.)

The Commissioner determined deficiencies in excess profits taxes on the ground that the reduction in equity invested capital under Section 718(b)(1) on account of the distribution of the General Leather Company stock was to be in the same amount (unadjusted basis for determining loss) by which Section 718(a)(2) required that equity invested capital be augmented on account of the original contribution of the same property to the taxpayer's capital. (R. 24, 38-39.) The Tax Court sustained the Commissioner's deficiency determination (R. 20-26) and the Court of Appeals affirmed (R. 48-53).

ARGUMENT

1. The decision below is correct. The equity invested capital of a corporate taxpayer, used as one of the methods of determining what profits were to be taxed under the excess profits tax, is purely a statutory concept.[1] Equity invested capital is not the value of the assets used by the corporate taxpayer during the taxable year. Unrealized appreciations or depreciations of property owned by the taxpayer do not affect the

[1] Section 712, Internal Revenue Code, added by Section 201, Second Revenue Act of 1940, c. 757, 54 Stat. 974, as amended, provides for a credit based on income under Section 713, or based on invested capital under Section 714, whichever results in the lower tax. The credit in this case was based on invested capital, which includes equity invested capital, as defined in Section 718, plus borrowed invested capital, as defined in Section 719.

amount of the credit, just as was true of the tax enacted during the prior war. *La Belle Iron Works* v. *United States,* 256 U.S. 377. Instead, the emphasis is on the capital invested by the stockholders and permitted to remain in the enterprise, such capital including not only direct capital contributions but also profits not withdrawn. Capital once contributed, but later withdrawn, diminishes equity invested capital. Thus, equity invested capital includes money paid in as capital contributions (Section 718(a)(1), *supra*), property paid in for stock, in the amount of its unadjusted basis for determining loss (Section 718(a)(2), *supra*), profits which have been capitalized by means of taxable stock dividends (Section 718(a)(3), *supra*), profits which have not been capitalized but which have not been withdrawn from the business, namely, the corporation's accumulated earnings and profits (Section 718(a)(4), *supra*), and a portion of new capital contributed (Section 718(a)(6)).

To the extent that prior profits have been withdrawn in the form of taxable dividends, such withdrawals will have reduced accumulated earnings and profits and, hence, the amount that would have been in equity invested capital except for such withdrawals. To provide for other withdrawals from the business, reductions of capital in effect, Section 718(a) and (b) provide that equity invested capital shall be reduced by the

amount of distributions which were not out of earnings and profits and which were made during previous years (Section 718(b)(1), *supra*) or during the taxable year (Section 718(b)(2), *supra*).

The ultimate issue in this case is whether there should be a residual effect on equity invested capital with respect to property once contributed by the stockholders to the corporation but withdrawn from the capital of the business long before the excess profits tax year. The General Leather Company stock, which was contributed to the taxpayer's capital in 1924, augmented equity invested capital by the amount of its unadjusted basis for determining loss (equal to its then fair market value) under the express provisions of Section 718(a)(2). Since the very same property was withdrawn from the business in 1931, the excess profits tax situation in 1940 and 1941 should be the same as though the stockholders had never made this particular contribution to the taxpayer's capital. While Section 718(b)(1) does not specify what basis should be used in reducing equity invested capital where there has been a reduction in capital by the return of physical property to the stockholders, it seems sensible to construe that section, as the lower courts did, as requiring the use of the same basis specified by Section 718(a)(2) for inclusion in equity invested capital with respect to physical property contributed to capital. Such a construction results

in giving the taxpayer credit for all capital contributions and profits which the stockholders have permitted to remain invested in the business. This is a rational interpretation of the Congressional intent which is supported by 7A Mertens, Law of Federal Income Taxation, Sec. 42.115; and II Montgomery's Federal Taxes Corporations and Partnerships (1946-1947), pp. 411-412. See also *R. D. Merrill Co.* v. *Commissioner,* 4 T.C. 955.

To include property contributed to the corporation in the amount of the basis specified in Section 718(a)(2), but to reduce equity invested capital under Section 718(b)(1) by the fair market value of the same property if it is withdrawn from capital by the stockholders, as the taxpayer would do, results from " * * * insisting on using as a base for tax purposes a figure that in itself has no relation to taxation." *Commissioner* v. *Wheeler,* 324 U.S. 542, 546. Thus, where, as here, the fair market value of the property when returned to the stockholders is less than the basis when it was contributed to the corporation's capital, and where the distribution is a return of capital which is not out of earnings and profits, the equity invested capital and the corporation's excess profits tax credit would be augmented by the difference. In the present case, for example, the taxpayer seeks a net credit in excess of $1,600,000 because of property no longer invested by the stockholders in the business. In a converse

situation, where the fair market value has risen, equity invested capital and the corporation's credit would be reduced. Yet, quite plainly, in neither situation would the property, which had been withdrawn from the corporation's capital in previous years, have anything to do with the stockholders' continuing investment or the corporation's profits earned during the excess profits tax year. Under the construction adopted by the courts below, both such corporations would be in the same position with respect to the effect of the distribution on equity invested capital. There is nothing in the statutory scheme which sanctions the interpretation urged by the taxpayer which would result in different treatment for these corporations, despite the similarity of their situations with respect to the capital still invested by the stockholders.

The infirmity of the taxpayer's reasoning seems to spring from its assertion (Br. 9) as a proposition "not open to question" that property sold at a loss affects earned surplus but does not affect equity invested capital. This statement is erroneous for, since such a loss would reduce accumulated earnings and profits, it would necessarily reduce what is included in equity invested capital under Section 718(a)(4). This misunderstanding of equity invested capital permeates the taxpayer's entire reasoning, such as its conclusion that, once capital has been embarked in the enterprise (Br. 11), "It makes no difference what has

become of it." The taxpayer's reliance on the taxable effect to the stockholders of the return of capital by a distribution in kind (Pet. 3, Br. 10, 12-14) is misplaced for this has nothing to do with what invested capital the corporate taxpayer possessed during the taxable year.

2. There is no conflict in decisions. While the taxpayer (Pet. 3) asserts a conflict with *La Belle Iron Works* v. *United States,* 256 U.S. 377, that case, construing the different provisions of the prior law (see *Brown Shoe Co.* v. *Commissioner,* 339 U. S. 583, had nothing to do with capital withdrawn from the business by the stockholders. The language of the opinion there, moreover, is in harmony rather than in conflict with the decision here, for it emphasizes the capital invested in the business, not the capital already withdrawn. The absence of a conflict is also apparent from the taxpayer's further assertion that this case presents a question which has not been decided before. (Pet. 4.)

CONCLUSION

The decision below is correct. There are no conflicting decisions. No other reason exists which would warrant further review of the case by this Court. Accordingly, the petition for a writ of certiorari should be denied.

Respectfully submitted,

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AUGUST, 1950.

☆ U. S. GOVERNMENT PRINTING OFFICE: 1950 856099 43

Office-Supreme Court, U.S.
FILED
SEP 5 1950
CHARLES ELMORE CROPLEY
CLERK

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Respondent.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

REPLY BRIEF FOR PETITIONER

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REPLY BRIEF FOR PETITIONER

Two statements in the Brief for Respondent seem to merit attention.

On page 7 it is said "the emphasis is on the capital invested by the stockholders and permitted to remain in the enterprise." It is submitted that "permitted to remain in the enterprise" has nothing to do with the matter. The contribution may have been in the form of a stock of mer-

chandise which may have completely burned the next day without any or adequate insurance coverage. Though the contribution thus does not "remain in the enterprise" invested capital is not affected.

On page 10 it is said in respect of a statement on page 9 of the Brief in support that "This misunderstanding of equity invested capital permeates the taxpayer's entire reasoning." The statement referred to in the Brief in support is "If property acquired by a corporation * * * is sold by the corporation at less than cost the loss does not affect *invested* capital but *earned* surplus only." What is done on page 10 of the Brief in opposition is to give the last quoted statement a meaning which on a fair reading it does not have. It was thought that by italicizing and thus contrasting the words "invested" and "earned" it was clear that "invested" was there being used in its ordinary dictionary meaning without any reference to its use in the Excess Profits Tax Law. Possibly "contributed" would have been a better word. At least it would have prevented any such argument as made on page 10 of the Brief in Opposition. Clearly if a corporation had invested (contributed) capital of $10,000 and earned surplus of $1,000 and then sold an asset at a loss of $2,000 the only effect would be on earned surplus. There would be no effect on invested (contributed) capital. Where a corporation has no earned surplus (petitioner had a deficit) there can be no possible effect on invested capital in any meaning of the term.

Respectfully submitted,

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